Internal Revenue Service

memorandum

CC:TL
Br4:RBWeinstock

date: 09 NOV 1987

to: District Counsel, Manhattan

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your October 16, 1987, request for technical advice with respect to this case which has been set for trial on [redacted] in New York.

ISSUES

1. Whether respondent is required by Tax Court Rule 142(c) to amend its answer and make affirmative allegations concerning the issue of a Foundation's Manager's knowing act of self-dealing raised in the petition?

2. Assuming that property was sold at its fair market value, is respondent bound by the private letter ruling holding that the sale of such property would not be self-dealing?

CONCLUSIONS

1. Respondent issued a deficiency notice to the petitioner for the private foundation excise tax imposed under I.R.C. § 4941(a)(1) as a self-dealer and not under I.R.C. § 4941(a)(2) as a foundation manager. Therefore, it is not necessary for respondent to amend the answer to assert that the act of self-dealing was a knowing one.

2. If the property was sold at its fair market value, respondent is bound by the private letter ruling stating that the sale would not constitute self-dealing.

FACTS

The [redacted], was an organization incorporated in [redacted] pursuant to Membership Corporation (not-for-profit) Law of the State of New York. The late [redacted], petitioner's husband, was the principal contributor to the foundation which was exempt under section 501(c)(3) and a private foundation. The foundation's primary function was making

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grants to charitable organizations. In [redacted] when the sale of certain land was consummated, the foundation's directors included petitioner, her children [redacted] and [redacted] and [redacted]. In [redacted], the Foundation's Board of Directors voted to divide the foundation into two separate foundations and transferred the assets to the new foundations in [redacted]

The [redacted] is a New Hampshire corporation engaged in the business of manufacturing [redacted] and [redacted] products. The company has [redacted] shares of common stock and [redacted] of preferred stock outstanding. The common stock is voting and the preferred is fully participating as to dividends and liquidation, but is non-voting. The [redacted] shares of common stock are held by a trust created by the late [redacted] with the duration of the trust being the life of the survivor of [redacted] and [redacted] and [redacted] along with their issue are the income beneficiaries of the trust, and upon termination of the trust, the trust's principal is distributable to the issue of [redacted] and [redacted], or to the Foundation if they have no issue.

The preferred stock was held in [redacted] as follows:

Stockholders	Number of Shares
[redacted]	[redacted]

[redacted]'s will created a marital trust and bequeathed a fraction of the residuary estate for the petitioner's benefit. As a result of disclaimers filed by [redacted] and [redacted], the balance of the estate will go to the foundation.

The [redacted], a [redacted] acre parcel of land located in [redacted] Florida, was purchased in [redacted] for approximately $[redacted] by the petitioner and her late husband. In [redacted], the petitioner and her late husband entered into a [redacted] sale and lease agreement with the [redacted]. In [redacted], in anticipation of the sale of the land to the Company, petitioner secured two separate and independent appraisals of the land. One appraisal valued the land at $[redacted] while the other valued the land at $[redacted].

On [redacted], the foundation and petitioner through counsel requested a ruling from the Internal Revenue Service that the sale of the [redacted] to the [redacted] would not constitute an act of self-dealing. A private letter ruling dated [redacted] was issued stating that based on the information furnished, and on the condition that the land was sold at its fair market value, the sale would not be an act of self-dealing under I.R.C. § 4941.

The land was sold for $[redacted] on [redacted]. On [redacted], the District Director for Manhattan District issued a statutory notice on the basis that the fair market value of the land was $[redacted], and therefore, petitioner had received a constructive dividend from the corporation of $[redacted]. 1/ Also, on [redacted], a separate notice of deficiency was issued determining that the sale was an act of self-dealing subject to the I.R.C. § 4941 excise taxes. It was determined that petitioner was also liable for the 5% excise tax imposed by section 4941(a)(1) for the taxable years [redacted] through [redacted] inclusive, and was also liable for the additional tax imposed by section 4941(b)(1) at the rate of 200% of the amount involved for the taxable year ended [redacted]. 2/

ANALYSIS

I.R.C § 4941(a)(1) imposes an initial excise tax on each act of self-dealing between a disqualified person and a private foundation at the rate of 5 percent of the amount involved. This tax is paid by any disqualified person (other than a foundation manager acting as such) who participates in the act.

I.R.C. § 4941(a)(2) imposes, in any case in which the tax of section 4941(a)(1) is imposed, an initial tax on a foundation manager who participates in an act of self-dealing between a private foundation and a disqualified person, knowing that it is such an act, a tax at the rate of 2.5 percent of the amount involved, with $10,000 being the maximum tax that can be imposed on foundation managers for any one act of self-dealing.

I.R.C. § 4941(b) imposes additional taxes in cases where the initial taxes of section 4941(a) have been imposed.

1/ Your request for technical advice relates solely to the section 4941 taxes and we do not address the question of whether petitioner received a dividend.

2/ We observe that the calculation of the section 4941 tax in the statutory notice was erroneous. The statutory notice determined that the act of self-dealing was a use of foundation assets by petitioner, and calculated the "amount involved" through a complex formula, reaching a tax for each year of $[redacted]. With respect to an indirect sale of property by a disqualified person to a private foundation, the amount involved is the greater of the fair market value of the property, or the amount received by the disqualified person, or $[redacted] Treas. Reg. § 53.4941(e)-1(b)(1). Therefore, the correct amount of the section 4941(a)(1) tax for each year should have been 5 percent of this amount, or $[redacted] a year.

Treas. Reg. § 53.4941-1(a) provides that the tax imposed by section 4941(a)(1) is imposed on the disqualified person even though the person had no knowledge at the time of the act that such act constituted self-dealing.

Treas. Reg. § 53.4941-1(b)(1) provides that the section 4941(a)(2) tax is imposed only in cases in which a tax is imposed by section 4941(a)(1), the participating foundation manager knows the act is an act of self-dealing; and the foundation manager's participation is willful and not due to reasonable cause.

Section 4941(d)(1) provides that the term "self-dealing" means any direct or indirect --

(A) sale or exchange, or leasing of property between a private foundation and a disqualified person; ...

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; ...

Section 4946(a)(1), in part, provides that the term "disqualified person" means with respect to a private foundation, a person who is:

(A) a substantial contributor to the foundation,

(B) a foundation manager (within the meaning of subsection 4941(b)(1),

(C) an owner of more than 20 percent of --

(i) the total combined voting power of a corporation ...

which is a substantial contributor to the foundation,

(D) a member of the family (as defined in section 4946(d)) of any individual described in subparagraph (A), (B), or (C),

(E) a corporation in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power, ...

Section 4946(c) provides that for purposes of section 4946(a)(1)(E) there shall be taken into account indirect holdings that would be taken into account under section 267(c), with an exception not applicable here. Under section 267(c)(1) stock owned by a trust shall be considered owned by or for its beneficiaries.

Issue 1.

Petitioner is a disqualified person within the meaning of section 4941 as the spouse of [redacted], a substantial contributor to the [redacted] (section 4946(a)(1)(D), and as a foundation manager (section 4941(a)(1)(B)). Therefore, she is a person liable for the tax imposed under section 4941(a)(1) for every act of self-dealing that she participates in with the [redacted]. As a foundation manager, she may also be liable for the tax imposed by section 4941(a)(2) for her knowing and willful participation as a foundation manager in an act of self-dealing.

The [redacted] is a disqualified person with respect to the Foundation because it is described in section 4946(a)(1)(E). All of the voting stock is owned by a trust whose beneficiaries are members of the family of a substantial contributor, and therefore, persons described in section 4946(a)(1)(A), (B), (C) or (D) own more than 35 percent or more of the total combined voting power of the company. Sections 4946(c) and 267(c)(1).

The section 4941(a)(1) tax is imposed on parties who participate in an act of direct or indirect self-dealing. In order to be liable for the section 4941(a)(1) tax, there is no requirement that a disqualified person act knowingly or willingly. The only requirements are one's status as a disqualified person and participation in an act of self-dealing. The fact that the disqualified person also is a foundation manager does add a requirement that one knowingly participate in self-dealing.

In contrast, the section 4941(a)(2) tax is imposed on a foundation manager, acting as such, who participates in a self-dealing act. The foundation manager's liability arises from causing or allowing the foundation to act or fail to act. The foundation manager's liability is not based on participating as a party to the act. The section 4941(a)(2) tax only is imposed if the foundation manager acted knowingly, willfully and without reasonable cause.

Examination of the notice of deficiency shows that the section 4941(a)(2) tax was not imposed in this case. If we were asserting the section 4941(a)(2) tax, then it would have been necessary to amend the answer to make affirmative allegations. However, petitioner's liability as a self-dealer in the present case does not depend upon whether her participation in the self-dealing act was "knowing" or "willful". Because only the section 4941(a)(1) tax is at issue in this case, it is not necessary to

amend respondent's answer to make affirmative allegations in this case. 3/

Issue 2.

Underlying the notice of deficiency with respect to the section 4941 taxes is a determination that petitioner's sale of land to the [redacted] constituted an indirect act of self-dealing. If petitioner sold the land directly to the foundation, it clearly would be an act of self-dealing within section 4941(d)(1)(A). While the term "indirect self-dealing" is not defined in the Code or Treasury Regulations, we believe that it encompasses transactions between disqualified persons and a corporation which is a disqualified person with respect to the private foundation and in which the private foundation possesses a substantial equity interest in. The regulations do provide several exceptions to "indirect self-dealing, but none of these apply to these facts. 4/

A private letter ruling was issued to the foundation stating that if the land was sold by petitioner to the company at its

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3/ Given the fact that the sale was only consummated after petitioner's attorney received a private letter ruling on the proposed transaction, we do not believe that the section 4941(a)(2) tax would be applicable in this case in any event.

4/ The ruling letter stated that the [redacted] was a controlled organization. In ruling that the sale of the land was not self-dealing if sold at fair market value, the ruling was probably based on Treas. Reg. § 53.4941(d)-1(b)(1) which provides that the term "indirect self-dealing" does not include certain arms length transactions involving controlled organizations. We believe that [redacted] is not a controlled organization within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5), even though it is controlled by disqualified persons. The Service has ruled that an organization is not a controlled organization where a disqualified person controls an organization in his or her own right, and not by virtue of acting in the capacity as a foundation manager, or aggregating his or her stock or position of authority with that of the foundation, then the foundation is not considered to control the organization with the meaning of the regulation. Rev. Rul. 76-158, 1976-1 C.B. 354. Therefore, the Treas. Reg. § 53.4941(d)-1(b)(1) exception does not literally apply, though logically its arms-length standard should also be applicable to transactions involving an organization that is not controlled. However, it is not necessary to address this point because the Service issued the ruling to petitioner stating that if the land was sold at its fair market value than the sale would not be self-dealing.

fair market value, then the sale would not constitute an act of self-dealing. This letter was in response to a ruling request made by counsel for both the foundation and [redacted]. A taxpayer generally cannot rely on a ruling issued to another taxpayer. I.R.C. § 6110(j)(3). In this case, the private letter ruling was issued to the private foundation and not the taxpayer. However, we note that the letter ruling specifically refers to the ruling request made on behalf of petitioner as well as the private foundation, we believe petitioner would have a strong estoppel argument if respondent were to assert that it was not bound by the ruling because it was issued only to the foundation. Our imposition of the self-dealing taxes in this case is based solely on the assertion that the property was sold for more than its fair market value or within the caveat of our ruling letter. If you determine that the land was sold for its fair market value, then the private foundation excise taxes in this case should be conceded.

We coordinated our response with the Exempt Organizations Technical Division (OP:E:EO). If you have any questions on this technical advice, please contact Ronald B. Weinstock at (FTS) 566-3345.

PATRICK J. DOWLING
Acting Director

By: _____
HENRY G. SALAMY
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